

Office of Investment and Innovation

Office Overview

June 2014

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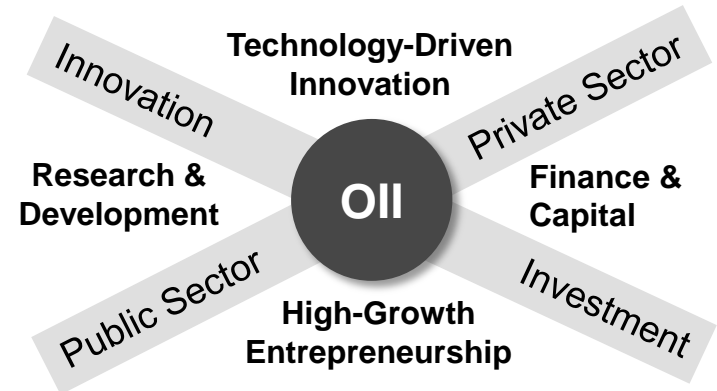
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Overview

SBA's Office of Investment and Innovation (OII) leads programs that provide the high-growth small business community with access to two things: financial capital and intellectual property. Our work is underpinned by public-private partnerships that operate on or along the dynamic intersection depicted here.



Small Business Investment Company (SBIC) Program delivers access to financial capital

\$4 billion authorization per year | \$19.85 billion of assets under management | 287 active SBICs

Small Business Innovation Research (SBIR) and Small Technology Transfer Research (STTR) programs support the research, development and financing of cutting-edge technologies

~\$3 billion annual set aside | ~\$38 billion granted since 1983 | ~145,000 awards granted | ~10 patents per day

Accelerator Program, Start-Up America and Demo Days support the American entrepreneurial ecosystem and deliver value to its constituents

Broad Impact Across Our Economy – Some Facts

SBIC

Since inception in 1958...

- ▶ ...SBICs have deployed **over \$67 billion** (~64% private capital) in American small businesses
- ▶ ...SBICs have made **over 166,000** investments
- ▶ ...**more than 2,100 funds** have been licensed as SBICs

SBIR/STTR

Since inception in 1982...

- ▶ ...SBIR/STTR programs have awarded **over \$38 billion** to research-intensive American small businesses
- ▶ 11% of awardees have attracted another **~\$65 billion** of venture capital
- ▶ ...the **450 thousand** engineers and scientists involved are one of the largest STEM talent concentrations in the world

The SBIC Program

The Small Business Investment Company Program is a multi-billion dollar, government-sponsored investment fund created in 1958 to bridge the gap between entrepreneurs' need for capital and traditional sources of financing:

- ▶ SBA invests long-term capital in privately-owned and managed investment firms licensed as Small Business Investment Companies (SBICs)
- ▶ For every \$1 an SBIC raises from a private investor, the SBA will typically provide \$2 of debt capital, subject to a cap of \$150 million
- ▶ Once capitalized, SBICs make debt and equity investments in some of America's most promising small businesses, helping them grow

SBIC Success Stories

| | | |
|--------------------|---------------|------------------------------|
| Costco | Amgen | Staples |
| Apple | Quiznos | Sun |
| Callaway | Adaptec | AOL |
| HP | Cutter & Buck | Intel |
| FedEx | Jenny Craig | Build-a-Bear |
| Outback Steakhouse | Nutri-systems | Adam's Respiratory (Mucinex) |

SBIR & STTR

Small Business Innovation Research (SBIR)

- ▶ A set-aside program for small business to engage in Federal R&D – with potential for commercialization
- ▶ 2.6% of the extramural research budget (> \$2 billion) for all agencies with a budget greater than \$100MM per year.

Small Business Technology Transfer (STTR)

- ▶ A set-aside program to facilitate cooperative R&D between small business concerns and U.S. research institutions – with potential for commercialization.
- ▶ 0.35% of the extramural research budget (>\$250 million) for all agencies with a budget greater than \$1B per year.

Milestone-Driven Award Process

Phase I | Feasibility Study or Prototype

- ▶ \$150 thousand maximum and 6 months

Phase II | Full Research and Development Effort

- ▶ \$1 million maximum and 24 months

Phase III | Commercialization Effort

- ▶ Private funds only

Participating Federal Agencies



SBIR/STTR Success Stories

Qualcomm

Symantec

iRobot

Genzyme

Nimble Systems

NanoMech

Autonomous Technologies

Adaptec

Ecovative Design

Children's Progress Inc

JENTEK Sensors

SQUID

Innovation Programs

OII's Innovation Initiatives support high-growth entrepreneurs and ecosystems

- ▶ **Accelerators** | \$2.5 million pilot program to work with platforms that provide mentorship, access to capital, and co-working space to new businesses in exchange for equity - key activities include:
 - ▶ Demo Day | Hosting demo day for accelerators, provide funding and enhance the channel
 - ▶ Startup U | Fostering startup ecosystems for universities
 - ▶ Network/ Educate Accelerators | “train the trainers” and increase quality of startups via best practice sharing
- ▶ **Crowdfunding** | Leadership role on crafting proposed regulations and their impact to stake holders along with educating the small business community on the new platforms
- ▶ **Small Business Tax Reform** | Working on proposed regulation, their impact on high-growth businesses along with educating the small business community on its implementation



Linking Innovation Industry and Commercialization (LINC)

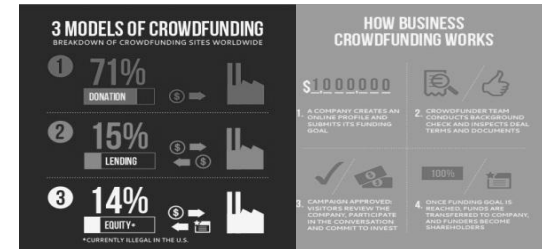


Butler Venture Accelerator Program



RampCorp

The concept of crowdfunding isn't entirely new. It's come about thanks to a progression of other funding ideologies.



Infographic Source: crowdfunder.com; prafulla.net/infographics/crowdsourcing-and-crowd-funding-infographic

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A Diverse Portfolio

The SBIC Program portfolio is diversified by strategy, location, industry and vintage year. Diversification helps ensure **the program continues to operate at zero subsidy.**

FY 2013 Results

- 34** new SBIC licenses issued
- \$2.2 billion** in new commitments
- 1,068** small companies financed
 - ▶ **\$3.5 billion** invested
 - ▶ **20%** of companies < 2 yrs. old
 - ▶ **30%** of companies are in low-to-moderate income areas or are minority- or women-owned
 - ▶ **\$2.3 million** average investment size
- Applications remain at peak levels
 - ▶ **80%** of pool comprised of first-time applicants to the program

Portfolio as of Dec. 31, 2013

- \$19.9 billion** in assets
 - ▶ **\$10.3 billion** in private capital
 - ▶ **\$9.5 billion** in SBA leverage
- 287 funds** in the SBIC portfolio
 - ▶ **14%** bank-owned or do not use SBA leverage
- Varied Investment Strategies**
 - ▶ Senior Lending
 - ▶ Mezzanine
 - ▶ Leveraged Buyout
 - ▶ Growth Capital
 - ▶ Turnaround
 - ▶ Venture Capital
- Impact & Early Stage Initiatives**
 - ▶ 7 funds with ~\$445 million AUM

5 Year View: FY'09 – FY'13

- \$11.6 billion** in SBIC financings of American small businesses
 - ▶ **56%** debt
 - ▶ **32%** debt w/equity features
 - ▶ **12%** equity
- Industry Diversity**
 - ▶ **25%** manufacturing
 - ▶ **14%** professional services
 - ▶ **12%** information technology
 - ▶ **9%** transportation
 - ▶ **7%** health & other care
 - ▶ **26%** all other
- Geographic Diversity**
 - ▶ Investments made in **43** states
 - ▶ SBIC located across the U.S.

The SBIC Public-Private Partnership at Work

The SBIC Program leverages the full faith and credit of the U.S. government to increase the pool of investment capital available to small businesses.



Role of Private Investors:

- ▶ Participate as “Limited Partners” in the SBIC
- ▶ Negotiate the fund structure and management fees with the SBIC manager
- ▶ Invest the matching funds needed for the fund to access SBA-guaranteed leverage

Role of SBA:

- ▶ Assesses fund manager qualifications and licenses funds as SBICs
- ▶ Generally provides up to \$2 of government-guaranteed debt for every \$1 of private capital, up to a maximum of \$150 million
- ▶ Regulates and monitors SBICs for compliance and performance

Role of SBIC Fund Managers:

- ▶ Manages all aspects of the fund, including LP relations and compliance with SBA regulations
- ▶ Establishes investment strategy
- ▶ Identifies small business investment opportunities
- ▶ Monitors and exits investments

Flexible Licensing

SBICs pursue a variety of investment strategies that each target a different segment of the market. The SBIC Program accommodates these funds with three license types.

| | Standard License | Impact Investment License | Early Stage License |
|--------------------------------|---|---|--|
| Investment Strategy | For applicants seeking the broadest investment mandate with few restrictions on their strategy or capital allocation. | Applicants commit to invest at least 50% of their capital in clean energy, education, low-income or rural areas. | Applicants commit to invest at least 50% of their capital in early-stage businesses. |
| Application Process | <ul style="list-style-type: none"> ▶ Rolling application process ▶ Applications processed on a first-in, first-out basis | <ul style="list-style-type: none"> ▶ Rolling application process ▶ Impact applications are expedited | <ul style="list-style-type: none"> ▶ Annual Call for Proposals ▶ All applications are reviewed together according to a pre-determined schedule |
| Private Capital Minimum | <ul style="list-style-type: none"> ▶ Generally \$15-20 million ▶ Most successful applicants raise at least \$10-15 million | <ul style="list-style-type: none"> ▶ Generally \$15-20 million ▶ Most successful applicants raise at least \$10-15 million | <ul style="list-style-type: none"> ▶ Minimum of \$20 million |
| Leverage Available | <ul style="list-style-type: none"> ▶ 2:1 ratio of SBA-guaranteed debt to private capital ▶ Maximum of \$150 million ▶ Applicants may also seek a Non-Leveraged Standard SBIC License | <ul style="list-style-type: none"> ▶ 2:1 ratio of SBA-guaranteed debt to private capital ▶ Maximum of \$150 million ▶ Applicants may also seek a Non-Leveraged Impact SBIC License | <ul style="list-style-type: none"> ▶ 1:1 ratio of SBA-guaranteed debt to private capital ▶ Maximum of \$50 million |

Flexible Financing

SBICs may access SBA-guaranteed leverage using several financing instruments. These debentures can each be used to finance a different type of small business investment.

| | SBA-Guaranteed Debentures Available | | | |
|------------------------------|---|--|---|--|
| | Standard | Discounted | Early Stage Standard | Early Stage Discounted |
| Standard Licensees | ✓ | ✓ | | |
| Impact Licensees | ✓ | ✓ | | |
| Early Stage Licensees | | | ✓ | ✓ |
| <i>Maturity:</i> | 10 years | 5 or 10 years | 10 years | 10 years |
| <i>Repayment:</i> | <ul style="list-style-type: none"> ▶ Semi-annual interest ▶ Bullet due at maturity ▶ No prepayment penalty | <ul style="list-style-type: none"> ▶ Issued at a discount ▶ No payments first 5 years ▶ Face value due at maturity ▶ 1 year prepayment lockout | <ul style="list-style-type: none"> ▶ Quarterly interest ▶ Bullet due at maturity ▶ No prepayment penalty | <ul style="list-style-type: none"> ▶ Issued at a discount ▶ No payments first 5 years ▶ Face value due at maturity ▶ 1 year prepayment lockout |
| <i>Interest Rate:</i> | Fixed upon issuance at premium over 10-year Treasury Note | Fixed upon issuance at premium over FHLB* cost of funds | Fixed upon issuance at premium over FHLB* cost of funds | Fixed upon issuance at premium over FHLB* cost of funds |
| <i>Eligible Financings:</i> | All financings that comply with SBA's basic investment criteria | Financings in Low-to-Moderate Income areas and Energy Saving Activities | All financings that comply with SBA's basic investment criteria | All financings that comply with SBA's basic investment criteria |
| <i>Fees:</i> | All SBICs must pay a 1% commitment fee, a 2% draw fee and a fixed Annual Charge | | | |

* Federal Home Loan Bank of Chicago (FHLB)

Small Business Investment Criteria

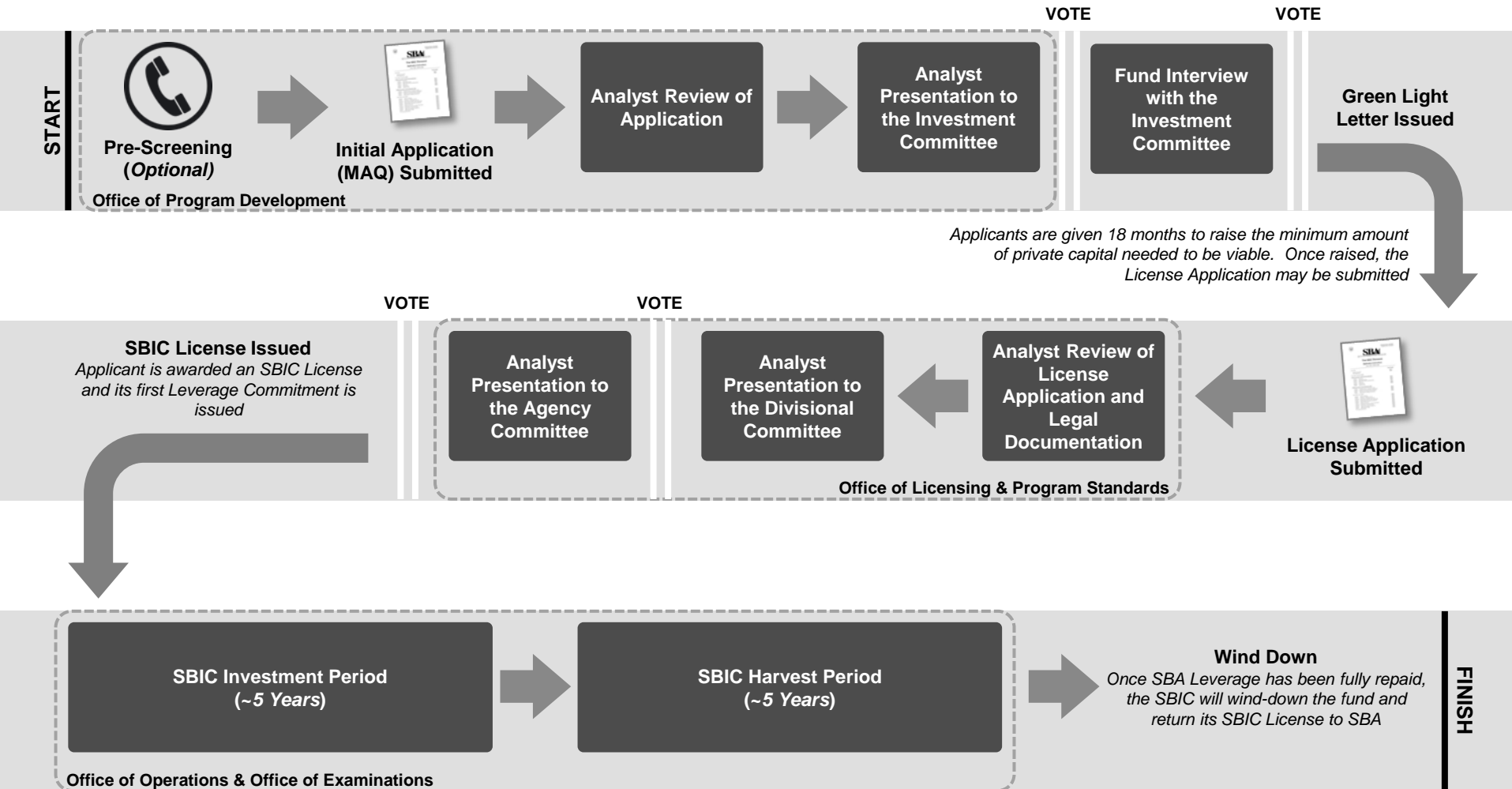
SBA has established a basic set of investment criteria to which all SBICs must adhere. These rules ensure the SBIC Program achieves its public policy goals without imposing undue restrictions on fund operations.

- ✓ SBICs **must** invest in “small” businesses, which are defined as those with less than \$18 million in tangible net worth AND average after-tax income for the preceding two years of less than \$6 million; OR, businesses qualifying as “small” under SBA’s N.A.I.C.S. Industry Code standards (generally based on annual sale or number of employees)
- ✓ SBICs **may** invest in businesses located anywhere in the U.S. or its territories
- ✓ SBICs **may** control a small business for up to seven years, or longer with SBA approval
- ✓ SBICs **may** invest using loans, equity securities or debt securities with equity features such as warrants
- ✗ SBICs **may not** invest in businesses with over 49% of their employees located outside the U.S. or its territories
- ✗ SBICs **may not** invest in project finance, real estate, farmland, financial intermediaries or passive businesses
- ✗ SBICs **may not** invest more than 10% of the total fund in a single portfolio company

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SBICs from Start to Finish



Rigorous Underwriting Criteria



Key Criteria Analysts Use to Assess an Applicant's Qualifications:

Manager Assessment

- ▶ Proven investment experience
- ▶ Balanced track record among principals
- ▶ Evidence indicating a cohesive and effective team
- ▶ Principals with strong, positive reputations
- ▶ Robust investment and due diligence process

Performance Analysis

- ▶ High quality track record of transactions analogous to those proposed for the SBIC
- ▶ Record of positive realizations
- ▶ Evidence past returns could have supported SBIC cost of leverage and met or exceeded targets
- ▶ Analysis of fund performance measured against peer funds

Strategy Evaluation

- ▶ Clearly articulated focus and investment thesis
- ▶ Evaluation of targeted transaction size, investment themes and type instruments to be used
- ▶ Clear indications proposed investments will fund eligible "small businesses"
- ▶ Compatibility of the proposed strategy with manager experience

Fund Structure & Economics

- ▶ Structure of LP preferred return
- ▶ GP carry, management fees and vesting schedules in line with industry norms
- ▶ Alignment of carry distribution with time dedication and level of responsibility
- ▶ Adequate fund infrastructure
- ▶ Evidence of fundraising traction

Time Frame:

- ▶ Pre-screening call with Investment Officer – 1 hour
- ▶ Analyst Review of Application & Presentation to the Investment Committee – 4-6 weeks

Thorough Legal Review

Licensing:

- ▶ Prior to the submission of the Licensing Application, applicants must have secured private capital commitments in an amount sufficient to ensure the fund's financial viability
- ▶ Analysts review the application, business plan, ownership diversity and coordinate a legal review with SBA's Office of General Counsel
- ▶ Licensing is contingent on the approval of the SBA's Divisional Committee and Agency Committee



Selected Legal Documentation Reviewed in the Licensing Process:

- ▶ Limited Partnership Agreement (LPA): Applicants are encouraged to use the SBA-approved Model LPA
- ▶ Capital Certificate: Compendium of signed commitment letters from the prospective limited partners
- ▶ Fingerprint cards: Each principal of a proposed SBIC must undergo an FBI background check

Time Frame:

- ▶ Analyst and Office of General Counsel Review – 3-6 months

Regulatory & Financial Oversight

Office of Operations & Office of Examinations:

- ▶ The Office of Operations serves as the primary point of contact for SBIC fund managers
- ▶ Analysts in the Office of Operations perform a variety of tasks:
 - Assist SBICs with the draw down of SBA-guaranteed leverage
 - Review and approve potential conflicts-of-interest
 - Process requests for the transfer of LP interests
 - Monitor financial health of SBICs

Key Reports:

- ▶ Financing Reports (Form 1031): SBIC managers must report information to SBA about the companies they finance
- ▶ Quarterly & Annual Financial Statements (Form 468): SBICs use an online system to report their financial results

Examinations:

- ▶ SBA's Office of Examinations assesses the regulatory compliance of SBICs with leverage once a year
- ▶ Examinations are conducted for SBICs without leverage once every other year



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The SBIC Investment Opportunity

Benefits of Leverage

- ▶ **Flexible Terms:** The duration of SBA's financing instruments can be easily matched up with short or long term investments.
- ▶ **Rapid Deployment of Funds:** The potential to capitalize as much as two-thirds of a fund with SBA leverage means managers spend less time fundraising and more time investing.
- ▶ **Increased Financial Scale:** SBA leverage allows funds to scale up their strategies and extend their financings to more businesses.
- ▶ **Potential for Enhanced Returns:** SBA-guaranteed capital is low cost and does not participate in profit.

Organizational Benefits

- ▶ **Flexible Fund Structure:** SBICs can utilize a variety of fund structures, including “drop-down” or “side-car” structures.
- ▶ **Exemption from SEC Registration:** SBICs are exempt from SEC registration, yet LPs benefit from SBA's careful monitoring of each fund's performance and regulatory compliance.

Friendly to Bank Investors

- ▶ **Exemption from the Volcker Rule:** Bank investments in SBICs are exempt from the 3% cap set forth by the “Volcker Rule” under the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL-111-203)
- ▶ **Community Reinvestment Act (CRA):** Investments in SBICs are presumed qualified for CRA credit.

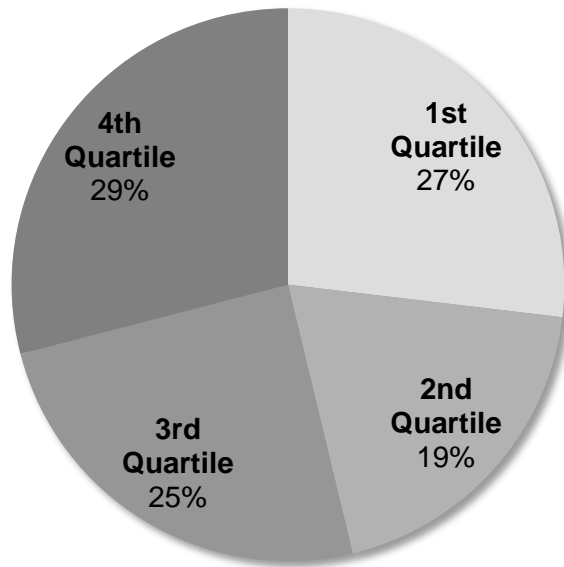
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Competitive Returns to Investors

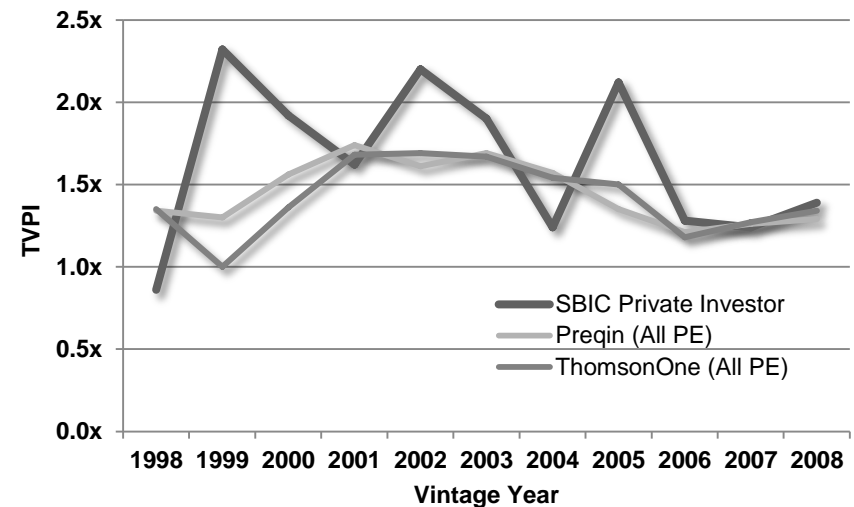
Distribution of SBICs by Private Equity Quartile

Based on SBIC Private Investor Net IRR & Preqin Quartiles (All PE);
Vintage Years 1998-2007; Results as of 12/31/2012; n=100



SBIC Private Investor Returns v. Benchmarks

Total Value to Paid-In Capital (TVPI); Pooled Basis as of 12/31/2012

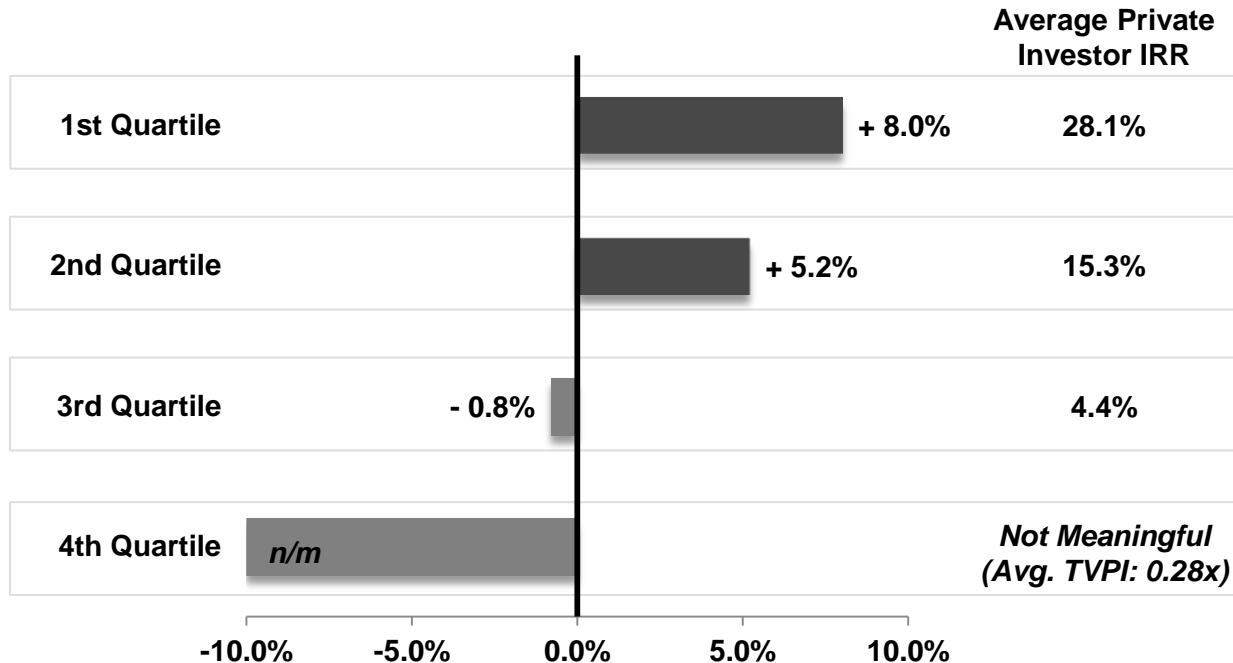


SBICs have historically delivered returns to private investors that are competitive with other funds in the market. The Net IRRs of SBICs licensed between 1998 and 2006 are distributed nearly evenly across industry quartiles. On a pooled-basis, these funds have also yielded cash multiples in-line with private equity benchmarks.

The Effect of Leverage

Average Impact of SBA Leverage on Private Investor IRR

SBICs Licensed from 1998-2008; as of 12/31/2012 (n=100)



As with other levered investment vehicles, the use of debt often amplifies the returns of an SBIC's underlying investment portfolio. Investors in well-performing SBICs may earn better returns than those available from comparable funds in the market. Those invested in poor-performers may see the opposite.

Private equity industry quartile data obtained from Preqin

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Driving Capital to Underserved Markets

In 2011, as part of President Obama's Start-Up America Initiative, SBA announced two initiatives designed to expand the reach of the SBIC Program to underserved communities and high growth startups.



Impact Investment Initiative

A \$1 billion initiative to channel private capital to underserved communities and sectors of national priority.

- ▶ Investment funds that apply for an Impact Investment SBIC License commit to invest at least 50% of their capital into SBA-defined “impact investments”
 - ▶ Low-to-Moderate Income Areas, Rural Areas, Economically-Distressed Areas; or
 - ▶ the Clean Energy or Education sectors
- ▶ Impact SBIC applications are processed on an expedited basis

Early Stage Initiative

A \$1 billion initiative to help high-growth businesses obtain their first round of institutional financing.

- ▶ Investment funds that apply for an Early Stage SBIC License commit to invest at least 50% of their capital into SBA-defined “early stage” companies.
- ▶ The Early Stage application process occurs once a year through FY2016.
- ▶ Early Stage SBICs may make use of both an Early Stage Standard Debenture and an Early Stage Discounted debenture.

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